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Analysis of proposals for a minimum subordinated debt requirement

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Abstract

Increasing market discipline has emerged as a major policy issue for banking regulators. The most prominent proposals for increasing market discipline would require banks to issue subordinated debt to the public. This paper explores the fundamental rationale behind mandatory subordinated debt proposals and their advantages and disadvantages. Our analysis indicates that a subordinated debt requirement will only modestly increase the risk sensitivity of bank costs at most large banks; however, we argue that there are substantial benefits to using subordinated debt as a market-based trigger for regulatory action. © 2002 Elsevier Science Inc. All rights reserved.

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1. Introduction

Increasing the effectiveness of market discipline in regulated financial markets has emerged as a major policy issue for banking regulators. For example, the recent Basel Committee consultative paper on reforming the international regulatory framework for bank capital cites market discipline as one of three pillars of the regulatory framework.

Perhaps the most prominent and potentially far-reaching proposal for increasing market

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discipline would require banks to issue publicly held subordinated debt that is unsecured, uninsured, and junior to bank deposits. While the recently passed Gramm-Leach-Bliley Act doesn't require banks to issue subordinated debt, it requires the 50 largest banks to issue long-term, unsecured debt rated in one of the top three investment grades if these banks control a financial subsidiary. National banks among banks ranked 51 to 100 in size must meet the same or "comparable standards" to control a financial subsidiary. However, the Gramm-Leach-Bliley Act does not require the debt to be publicly held.

This paper explores the fundamental rationale behind the various mandatory subordinated debt proposals, and discusses the advantages and disadvantages of these proposals. Since a number of existing proposals have received attention, the paper covers what we believe are the core issues associated with subordinated debt without comprehensively discussing all the nuances of the different proposals. To give the paper greater focus, we concentrate the analysis on proposals mandating the issuance of publicly held subordinated debt securities, i.e., tradable public debt securities that are held by nonaffiliated third parties. Concentrating on the issuance of publicly held securities allows us to avoid many of the complex issues of designing a rule for privately held subordinated debt. As we discuss below, it is unlikely that small banks can feasibly issue such securities, and therefore our analysis will only be relevant for large institutions. We defer discussion of the various proposals for a subordinated debt rule specifically for small institutions.[1]

Our paper concentrates on whether or not, as a matter of policy, large banks should be required to issue subordinated debt. Mandatory subordinated debt proposals aim to create a class of financially sophisticated creditors who are subject to loss if a bank becomes insolvent, who are unlikely to be protected by implicit government guarantees, and who won't receive higher returns from increased risk taking. These creditors would have a substantial financial incentive to monitor, assess, and price bank risk. Early proponents such as Benston, Eisenbeis, Horvitz, Kane, and Kaufman (1986) as well as later proponents such as the Shadow Financial Regulatory Committee (2000) and Evanoff and Wall (2000) argue that higher levels of subordinated debt increase market discipline by making the bank's costs more sensitive to risk. They add that, for regulators, yields in the subordinated debt market will be clear signals of the private market's view of the bank's risk. These proponents say that, in the absence of the strong market discipline and clear signals that subordinated debt holders can provide, the banking system must rely too much on supervisory examinations to monitor banking risk and too much on regulation to control it. They point out that, like equity, subordinated debt is a cushion for the deposit insurance fund and uninsured depositors against a bank's losses.

In order to provide a bank with market discipline and give signals about the bank to regulators, private investors must hold instruments whose value is threatened when an institution takes risk. Why is subordinated debt so sensitive to risk? Subordinated debt is both uninsured and unsecured. If a bank fails, subordinated debt holders receive payment only after all senior creditors, including insured and uninsured depositors, receive complete payment. The position of the claim thus increases the severity of the subordinated bondholder's loss in the event of a bank failure.

From this vulnerability to loss flows the incentive to discipline. In principle, holders of subordinated debt can impose market discipline on a bank directly or indirectly. They

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